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# Democracy and Growth in Brazil


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# Democracy and Growth in Brazil[1]
**Revised Version**

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## 1 – Introduction

Democracy is a relatively recent achievement in Brazilian history. Since the end of the imperial era in late 19th century, the country has experienced two long periods of dictatorship in 1930-45 and in 1964-85. For most of last century, political participation was rather limited. Evolution towards democracy was convoluted, moving forward and backwards up to mid-1980s, when mass democracy was finally established.

Brazil's economic development has been equally convoluted. In the last century, many years of strong economic growth were followed by severe economic crises. Fiscal and external disequilibrium were common, as was high inflation. Government played a central role in the country's economic development, financing public and private investment, coordinating production decisions, providing protection to selected sectors and setting prices.

Broad government intervention has been a major feature of Brazil´s history. For many decades, government economic intervention has been accepted as essential to assure investment and economic growth. Economic development was regarded as a national project, to be led by public policies carried out by government agencies. This has been true under both democratic and undemocratic government.

The economic literature defines "rent-seeking" as the process by which certain groups obtain privileges and benefits from government agencies. It is

[1] We thank to Ana Carla Abrão Costa, Carlos Eduardo Soares Soares Gonçalves, Flávio Stéfani Machado, Mansueto Almeida, Marcos José Mendes, Rozane Siqueira and Sérgio Lazzarini for comments, references and data. Samuel Pessoa has been very generous and made several comments. Simon Schwartzman was careful in his comments and revisions in a first version. Anne Applebaum made a very careful editing of our first version.

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[3] Gibraltar Consulting.

commonly understood as a means by which private interests obtain special favors from government agencies, often by obscure mechanisms and negotiations. In this paper, we propose the term institutionalized rent-seeking in order to broader its original meaning. It refers to the existence of discriminatory policies intended to provide privileges or benefit specific groups, often imposing non transparent costs upon the rest of society, extending the standard definition of rent-seeking in three aspects.

First, discriminatory policies are perceived to be a legitimate and essential aspect of public policy in order to foster economic growth and to mediate social and economic interaction. It is the role of government to select companies or sectors to be benefited by specific public policies in order to promote development.

Second, political pressure by organized minorities may be as influential as economic ones. Minority groups, for example, long seen as underrepresented in the political arena, have had their demands for specific policies and benefits increasingly satisfied by government agencies intervention. We call this phenomenon *reverse capture*: Instead of public agencies captured by a regulated industry, public agencies are captured by organized minorities.

Third, the existence of special interest groups may be the outcome of public policy and not its cause. Government policies may intend, for example, to provide a temporary protection or incentive in order to develop some economic sector. However, the later removal of protections and incentives may face the opposition of companies and employment created by policy itself. If development policy fails, and sectors do not become competitive, opposition may be even stronger politically, as removing privileges could mean the collapse of several companies and unemployment.

In the case of Brazil, government intervention to protect selected sectors and provide specific benefits has been seen as a legitimate, and necessary, mechanism to induce economic development. Several public agencies were created in the last century in order to provide stimulus to private investment, to coordinate economic decisions, to intervene in specific markets and to provide protections from external competition. The range of regulated sectors was quite impressive up to re-democratization in the mid-1980s, as we argue in this paper. Much more than the specific sectors regulated, what distinguish Brazil are the extension and detail aspects of government intervention.

In the first half of last century, Brazil's underdevelopment was understood as a consequence of a coordination failure. The country was mostly an agricultural economy and the absence of a broad industrial sector was perceived as a restriction for economic development. Moreover, there was a lack of long-term funding to investment. Economic policy aimed at providing incentives and protections to selected sectors. Government also coordinated private decisions in order to assure market demand as well as infrastructure and the access to inputs and capital goods. Private sector growth would be the outcome of government intervention.

Under democracy, rent-seeking behavior was not restricted to economically powerful groups but was also found among other kinds of groups whose welfare was thought to be key to the government's legitimacy. Discretionary policies, specific protections and money transfers from public agencies were understood as legitimate mechanisms to allocate resources and foster economic and social development. Either way, the underlying costs of government interventions are not perceived due to its diffuse nature and lack of transparency. Benefits are tangible for the ones who receive them, while their social costs are not.

Over time, incentives, protections and privileges have proliferated. Now they go far beyond usual tax incentives and cash transfers embedded in government budget. Subsidized loans, protectionism, price controls, off-budget money transfers, mandatory cross-subsidies in credit markets via earmarked loans: these instruments are not accounted for in the budget and are often used by government agencies without disclosure of their impact on the rest of society.

This is a distinctive feature of Brazil's political processes: government agencies are able to provide privileges and benefits without going through the usual political representation and public budget deliberation. Furthermore, in several cases there is no accountability of costs imposed on the rest of society, much less control analysis of public policies targets and their actual outcomes.

The political process behind these government interventions is decentralized in several cases. Organized civil society points out the need to protect some specific group, calling for example for the extension of health insurance, or for the regulation of market prices. Government agencies are then mobilized in order to implement measures that meet these demands. These policies provoke little comment or debate. In the case of credit market, for example, there is little discussion on the cross subsidy implied by subsidized loans that penalize the remaining credit operations.

Rent-seeking, once established, is difficult to end. Beneficiaries fight against change, becoming an important obstacle to reform. The diffused nature of the costs weakens political opposition. Even policies intended for a short period, once introduced, create special interest groups that defend their maintenance. The result is a large state that fails to deliver adequate income distribution and growth.

At the same time, there is an inevitable conflict between rent-seeking and democratic institutions. Opacity renders democratic deliberation on public policy impossible. In addition, rent-seeking by definition limits access to government benefits to selected groups. Privilege, by its own nature, has to be conceded to a few.

Finally, rent-seeking creates economic distortions which ultimately produce lower growth and limit the improvement of income distribution. Government's failure to constrain budgets and make choices based on nationally agreed priorities exhausts resources. In Brazil, the national tax burden has risen from around 25% of GDP in mid-1980s to current 37%, higher than the ones observed in most developing countries.

The Brazilian state is now at a crossroads. Taxation cannot be increased much further. But social demands are still high, especially after years of excesses in the fiscal policy, higher inflation, low growth and, more recently, social unrest. Demands for better public services, especially healthcare and education are high. This agenda requires a far more efficient government intervention and far more careful political choices. It also requires a different kind of public debate, one which, so far, Brazil's political parties do not appear to be sufficiently well prepared to hold.

## 2 – Growth versus democracy in the economic literature

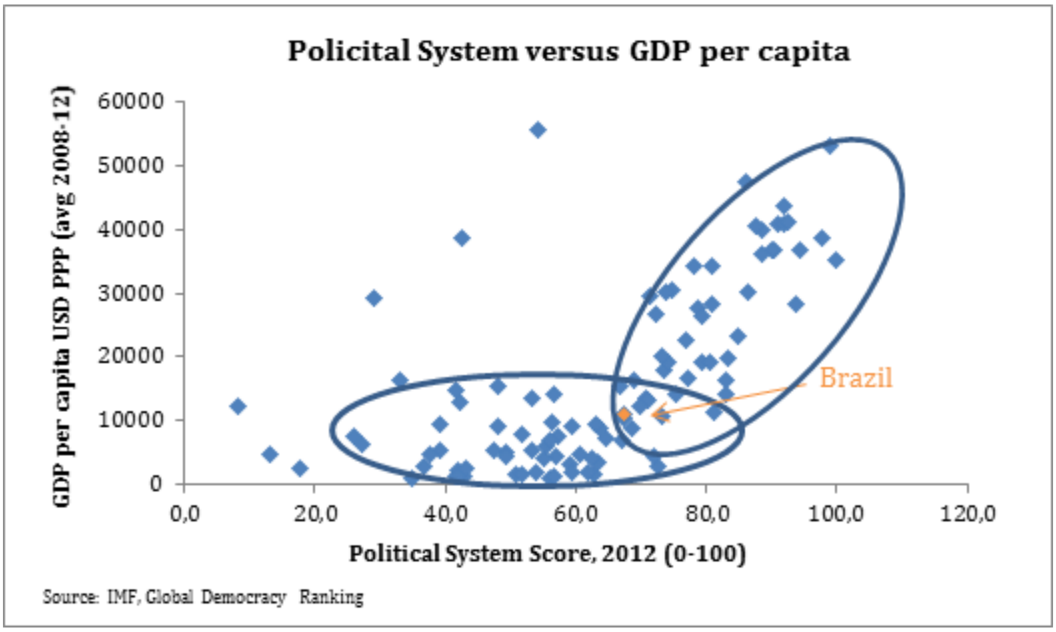
In the last two decades, following Douglass North´s contribution, academic research has systematically pointed out the importance of institutions for economic growth, being the most successful hypothesis for explaining the differences in income among countries. Institutions and general rules delimit incentives for individual behavior, including production and investment, which ultimately leads to growth.[4]

Empirical research from the end of 1990s onwards have been remarkably successful in showing that adequate institutions for growth are the ones that secure property rights, provide stable economic environment and produce efficient incentives for private decisions. Rule of law, judicial systems, and market regulations have been shown to be relevant to explain income disparities among countries.[5]

One might expect that democracy would be an additional factor, but that does not seem to be the case. The relation between democracy and per capita income displays a curious picture that shows a large diversity of political regimes or degrees of democracy among poor countries, while when it comes to richer ones, the diversity is reduced, with a much clearer relation between democracy and income (Chart 1). The more distant a country is from the technological frontier, the least predictable seems to be its political regime. The richer ones, on the other hand, tend to have fully established democratic regimes. Democracy seems to be a fate for most of the rich, even though it alone does not indicate the future of the poor.

[4] For a survey on growth evidence, see Aghion, and Howitt (2009).
[5] See Pincus and Robinson (2011) and Acemoglu and Robinson (2012).

**Chart 1**




Lipset (1959) proposed a causality relation from economic development to democracy.[6] Constitution and stability of democratic regimes may depend on the development of institutions as well as social and economic conditions: prosperity, education, existence of a middle class and absence of severe inequalities, rules allowing opposite parties and freedom of speech, and a set of beliefs accepting the rule of law and human rights.[7]

Empirical evidence does not support any hypothesis of causality between democracy and growth.[8] Acemoglu, Johnson, Robinson and Yeared (2008) showed that the relation between democracy and growth becomes non-significant once one controls for country fixed effects.[9] This suggests the existence of country invariant factors that affect the evolution of both growth and democracy over time, and once these specific factors are taken into account there is no causality between both variables. They propose that due to historical reasons, some countries have fostered institutions that protected rule of law,

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[6] See Lipset (1993), Barro (1999) and Przeworski and Limogi (1993).

[7] See Lipset (1993) for a detailed discussion of these conditions.

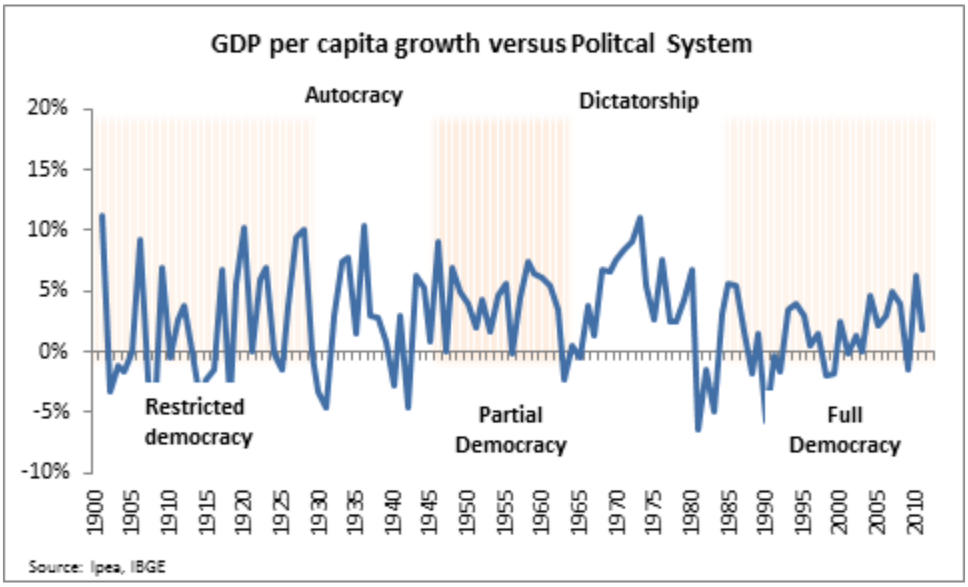
[8] Barro (1996) studies a panel of several countries and controls for additional institutional factors such as rule of law index and share of government consumption on GDP, in which case there is no significant impact of democracy on growth.

[9] Fixed effects are time independent effects that are possibly correlated with the regressor. If omitted, it biases the estimate of the independent variable impact on the estimation.

property rights, and growth, and, at the same time, have led to a more democratic participation and social inclusive policies, such as education.

The absence of correlation between democracy and growth is also a feature of the Brazilian experience (Chart 2). Democracy and authoritarian regimes alternated a few times in the last century. Similarly, business cycles have been unusually wide. Periods of robust economic development have been followed by severe crises and years of low economic growth. Democracy and growth, however, do not seem to be correlated.

**Chart 2**




Institutions, however, are the outcome of society's choices, and people rather to be rich than poor. If there are institutions that provide more income in the long run, why should one choose less? Why do some countries choose a set of rules that lead to a Pareto inferior equilibrium? Why are specific institutions chosen in certain countries and not in others? This is the subject of next section.

### 3 – Colonization, Development and the Origins of Rent-seeking

At the root of political and economic choices made by Brazil throughout its history is its colonial past, which distinguishes Brazil and other Latin American countries from North America´s countries.

In a series of influential papers, Engerman and Sokoloff proposed that natural endowments and population size were decisive to the pattern of colonization process – exploration versus settlement -, which shaped institutions and influenced importantly the future economic development of American colonies.[10]

Following a similar path, Acemoglou, Johnson and Robinson (2001, 2002) investigated the relevance of the colonization model to explain income differentials nowadays among American countries, as institutions built in the colonial period have persisted over time.

The climate and conditions of North America induced settlement and the production for local consumption, while reproducing several aspects of the original life in Europe. The model that prevailed was one of a more egalitarian society with smallholdings trading with neighbors in a competitive production of grains, leading to specialization, logistics, innovation and gains of productivity.[11] Settlers adopted institutions to protect property rights and guarantee the enforcement of contracts, and introduced institutions that replicated their European counterpart. Society started more egalitarian, and initiatives that threatened this backdrop had been less successful.

Tropical areas, on contrast, provided favorable conditions to produce efficiently valuable goods to Europe by exploration of land and labor. The intention was not to settle, but to explore natural resources. Colonization induced large-scale production and controls that enabled income appropriation by local and metropolis elites via government mechanisms. This growth model required institutions to enforce rent-seeking mechanisms, which resulted in an unequal society and concentrated access to political power. Government rent-seeking mechanisms were an essential part of this model. It is interesting to notice that more than half of Portugal government income came from transfers from Brazil in this period, according to Mattoso (1993).[12]

[10] Engerman and Sokoloff (1997, 2012), and Sokoloff and Engerman (2000).

[11] Sokoloff and Engerman (2000).

[12] We learned Mattoso evidence from Caldeira (1999, p. 229), which has a very original and provoking economic analysis of Brazil in colonial times and its economic activity.

At the end of the colonial period, American colonies displayed a surprising division. There were two Americas. In the north, settlers produced mostly for domestic consumption, and more egalitarian. The several areas in south were richer due to trade with Europe, but unequal. The Caribbean had the highest per capita income, overcoming North America until the nineteenth century.[13]

After independence, however, development paths inverted and tropical areas underperformed in comparison to North America, a pattern that persisted during the twentieth century. Acemoglu, Johnson and Robinson (2002) appropriately referred to this process as a "Reversal of Fortune". Institutions adequate to colonial periods persisted after independence movements and proved to be less suitable for market economies.

If growth trajectories inverted, the same cannot be said about political participation and income distribution. In former exploration colonies, such as Brazil, high inequality and restricted political participation remained after the colonial period,[14] along with poor access to education.[15]

Why have sub-optimal colonial institutions persisted? Why did tropical areas choose not to follow the North American institutions that proved to be more successful after the late nineteen century? Why has Latin America fell behind? Why have some democracies flourished and revealed to be resilient while some have proved to be very susceptible to current events?

Given the rules of the game, defined as institutions and incentives that rule individual behavior, people make choices to maximize their welfare. Whether that implies a Pareto inferior equilibrium, it is either because people do not perceive the benefits of changing the rules or because some groups with veto power that would be worse off in the new environment could obstruct changes, while society has no credible way to compensate them for possible losses.

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[13] For example, Cuba per capita income was 167% of the US in 1700 and 122% in 1800, according to Sokoloff and Engerman (2000).

[14] Sokoloff and Engerman (2000) present data on voting rules as well as literacy rates for several American countries in the nineteenth century.

[15] Sokoloff and Engerman (2000) argue that the importance public primary schools were recognized all over America in the late 1800s; however only in US and Canada they were actually implemented.

This seems to apply to rent-seeking societies, which rely on institutions that concede special benefits and privileges to selected few and restrict the participation of remaining social groups.[16] This design ultimately helps to explain to the survival of this inferior equilibrium.

In Brazil, rent seeking is quite stable, despite its sub-optimal outcome. The long prevalence of rent seeking has several sources. First, it reflects widespread beliefs.[17] There is a common view that as Brazil is far from the technological frontier, it would require alternative policies to catch up. Furthermore, for several decades in the last century, strong government discretionary intervention was successful in generating high economic growth. Secondly, there is a good deal of uncertainty about alternatives. Many worry, for example, about the specific consequences of trade liberation on their particular market.[18]

Third, rent seeking policies create politically vocal groups that depend on those policies and react to proposed changes. Fourth, the opacity and hidden costs of benefits makes it more difficult a public discussion base on cost-benefit analysis of the policies, even after re-democratization. Rules and procedures are adjusted to beneficiaries needs, and costs are diffused throughout society. There is almost no timely enforceable evaluation of policies' outcomes. Once conceded, privileges are somewhat protected from public discussion, fixed by several legal mechanisms that make harder future reversal.[19]

## 4 – Historical perspective

Since colonial period, Brazil has experienced many political cycles. Yet throughout this long period, rent-seeking mechanisms were not only preserved

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[16] For an economic model of rent seeking, see Barelli and Pessoa (2010).

[17] According to Greif (2006), institutions should reflect society or decision makers´ beliefs for the political and economic processes to be sustainable. Moreover, the system needs to deliver what expected by society. Otherwise, questionings about rules and institutions would arise, leading to a reassessment of the policies undertaken.

[18] See, for example, Rajan and Zingales (2006) for a theoretical model in which uncertainty prevents reforms.

[19] Tullock (2005) proposed the first model of rent seeking, a term later introduced independently by Krueger (1978). Tullock works anticipate Douglass North's conjecture of the role of Glorious Revolution in England posterior economic development.

but also enhance. They were accepted as essential to the country's development project. The purpose of government, many believed, was to provide protection, incentives and benefits to selected sectors in order to promote growth.

After 1929, these assumptions became explicit. Economic development became primarily a government responsibility. This was not unique to Brazil: many countries in the 1930s and 1940s leaned towards protecting economies. The spread of nationalism and the international economic crisis persuaded governments to encourage domestic production and lower dependency on trading.[20]

During the long Vargas dictatorship (1930-1945), political rights were limited and government increasingly assumed the role to mediate both economic and political decisions and conflicts. Government agencies monitored and played an important role in investment decisions and resource allocation, as well as in mediation of social conflicts. Special courts and rules severely limited private agents' scope to negotiate, for example in the labor market.

Intervention in the economic sphere was equally widespread. Several restrictions and government agencies limited market outcome to allocate goods and services. Government arbitrated many prices besides quantitative restrictions on several markets. The invisible hand of Adam Smith was replaced by a government hand, not invisible, however quite diffuse and opaque. [21]

After World War II, under a restricted or "elite" democracy, Brazil again chose a strategy that put government at the center of its development project, following many developing countries in Latin America. The ideological framework that provided a justification for government's intervention was called "National Developmentalism".[22] According to this view, underdevelopment was the outcome of lack of coordination and lack of resources to finance private investments. The public sector was meant to overcome these limitations by granting protection and adequate incentives to selected economic sectors.

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[20] For a general overview of Brazilian development, the role of institutions and government policies, see Left (1991). For a discussion of Brazil's response to 1929's crises and the beginning of the National Developmentalism project, see Malan, Bonelli, Abreu and Pereira (1980).
[21] See Abreu (1990b).
[22] Bielschowsky (1988) summarizes the National Developmentalism Ideology.

Industry was the sector selected for protection. Income generated by export agriculture was transferred to the industrial sector through many mechanisms, including taxation on several agricultural goods and a complex system of multiple exchange rates in the 1950s. Along with trade barriers, these protected the industrial sector from external competition and provided incentives to import inputs and capital goods.[23] Beyond that, the government also coordinated production and investment decisions with the private sector. Several public monopolies were created, from oil to reinsurance, and state owned companies provided public utility services. Government also supplied infrastructure and public banks. [24]

Government funds financed both private and public investment, such as the construction of a new capital, Brasilia. Nevertheless, forced savings and increasing indirect taxes did not prevent large public deficits and inflation acceleration. Still, high inflation was considered the result of supply restrictions rather than excess demand to be tamed via monetary and fiscal discipline.[25] Therefore, policy recommendation was to stimulate investment and production in order to relieve supply restrictions.

By late 1950s, macroeconomic imbalances led to high inflation and severe external restrictions. The Cold War added heat to an already difficult economic and political environment. Political instability and social unrest increased, with claims for a more equality. The combination of privileges and benefits to specific groups and sectors, lack of accountability of public resources, macroeconomic instability and growing social demands became explosive. The worsening of economic and political conditions in the early 1960s led a military coup in 1964, which ended in a 21 yearlong dictatorship.

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[23] For the economic history of this period, see Abreu (1990a).

[24] For the history of the institutional development that supported National Development in Brazil, see Campos (2004). By the end of the century, BNDES has become one of the largest development banks in the world. There is an extensive literature on the role of government in promoting development and the reasons behind the few cases of success but less debate around the more numerous cases of failure. Bhagwati and Panagariya (2013) discuss the failure of government intervention in India and provide some general discussion on public policy, growth and development. See, also, Pack and Saggi (2006) and Robinson (2009). For the Latin America experience, see Edwards (2010). For a more optimistic view of some public interventions to foster growth, see Rodrik (2007).

[25] For a survey of this economic perspective in Brazil up to late 1970s, see Bielschowsky (1988, section 2.3.4) and Pinto, Assail, Prado e Marinho (1978).

Economic crisis and political centralization were the ingredients for unexpected economic reforms in mid-1960s. Several liberal market-oriented reforms were carried out along with government spending control. To mention a few, the creation of the Central Bank, regulation of capital markets and the introduction of several credit instruments. Liberal reforms induced productivity gains and, in conjunction to a favorable external environment, fostered growth for the next years.[26]

As growth rebounded in the late 1960s, however, the usual instruments of economic policy resumed and enhanced, such as strong government intervention, incentives and concessions of privileges and price controls. Fiscal policies became increasingly expansionary leading to inflation acceleration and rising current account deficit. The macro policy regime was clearly one of fiscal dominance, meaning the inflationary financing of fiscal deficits. As a response, government created several instruments to introduce the indexation of the economy, aiming at postponing macro policy adjustments.

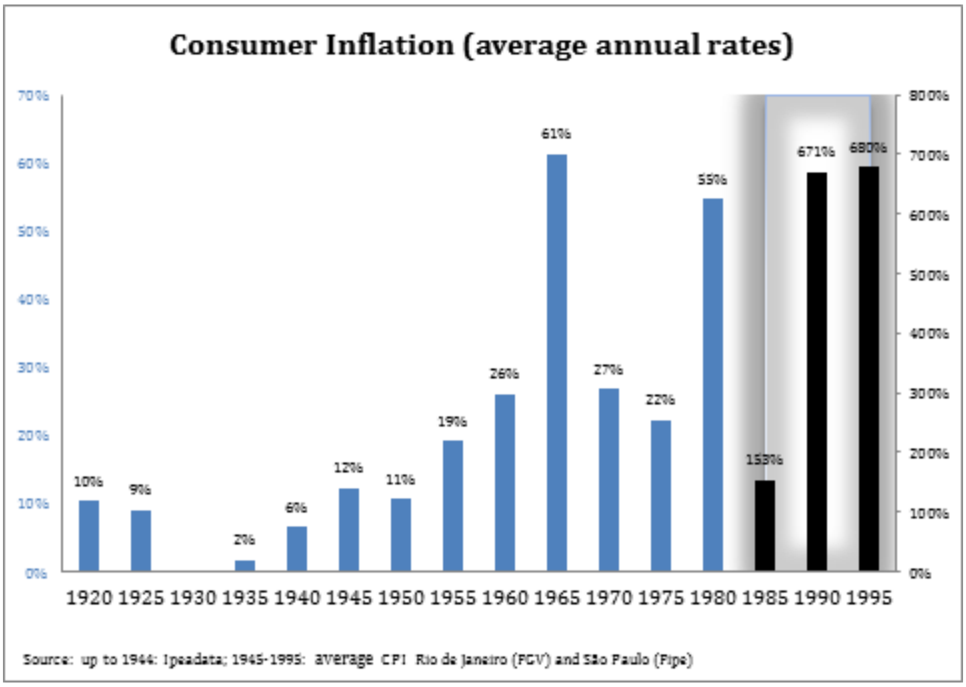
Government reaction to the severe mid-1970s was to "double the bet" and reinforce the National Developmentalism project, this time supporting imports substitution. Sectors chosen to receive government funding and protection ranged from naval industry to capital goods, basic sectors and infrastructure.

Government decision to cope with inflation was to strengthen the indexation mechanism instead of promoting a fiscal consolidation, which turned inflation dysfunctional in the 1980s.

Chart 2 shows the evolution of annual inflation at five years interval. Due to the impressive increase of inflation after 1980, the three last five-year have a different scale on the right side.

[26] For an empirical investigation of reforms and the impact on growth, see Veloso, Villela and Giambiagi (2008). Lara Resende (1990) provides a description of economic policy at that time.

**Chart 2**




Unexpected high inflation, however, was not the only government finance mechanism. Brazil distinguishes itself by the existence of many financing instruments available to provide privileges and benefits away from public scrutiny. The lack of transparency of costs and the lack of valuation of outcomes is a common feature of rent-seeking models, as emphasized by Buchanan (1967).[27]

National Developmentalism delivered robust growth until the end of 1970s, but produced an unstable macroeconomic environment, frequently rocked by external shocks or internal crises.[28] On average, growth rates were robust, close to 7% a year, from early 1950s to late 1970s. However, these numbers may also reflect a rapidly growing young population. Growth rates per worker were high but not superior to other development countries at that period, such as Korea.[29] Inequality of income was high and worsened

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[27] We thank Rozane Siqueira for this reference. A forthcoming paper by her and coauthors emphasizes the rent-seeking nature of government taxes and money transfers in Brazil.

[28] Carneiro and Modiano (1990).

[29] Korea had a similar development project, largely based on industrial policy and government intervention. However, government budget remained relatively balanced during most of second half of last century, resulting in much lower inflation rates. The economic intervention was concomitant to large investment in education. Furthermore, benefits and protections were limited are coupled with foreign competition. Transparency of public benefits, accountability of policy outcomes and social investment distinguish the Korean experience from the Brazilian one.

significantly in the 1970s. The provision of standard public goods, as education and healthcare services, lagged behind even some much poorer countries than Brazil. In the beginning of the 1980s, on the back of Volcker´s monetary tightening, a severe crisis disrupted. The growth model collapsed. On the political side, social pressure led to re-democratization and waves of deep and broad reforms.

## 5 – Re-democratization

The regime shift in mid-1980s led to the 1988 constitution and democratic institutions. Larger social participation – some 10,000 unions were created – and more vocal social demands began to play an important role in shaping the economic agenda. Public pressure for price stabilization, higher economic growth and more equality were high.

In the first ten years, debate and policy actions were concentrated in prices stabilization strategies, which limited the scope for a broader economic agenda. Moreover, the political environment was troubled, due to a stream of unsuccessful stabilization plans, which culminated with the resignation of President Collor (1990-1992) - the first president democratically elected by direct voting - amid a severe economic crisis and corruption scandal.

Still, some important market-oriented reforms were implemented in the period: gradual trade and financial liberalization and the start of a privatization program. Moreover, consumer protection agencies were created.

Popular demand for macroeconomic stability led to the election of President Cardoso (1995-2002), the finance minister who had launched the successful stabilization plan, "Plano Real" in 1994. The consolidation and sustainability of low inflation required a sound fiscal regime and led to several reforms, including the pension system and a broad privatization program, followed by the creation of regulatory agencies.

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For an analysis of Latin American development process and some comparison to East Asia and Korea for that matter, see Edwards (2010).

Taming macroeconomic volatility was critical for accelerating growth and improving income distribution. Some experiments for improving income distribution started in this period, via cash transfers policies and restoring the purchase power of minimum wage. A particular successful program was the "*bolsa-escola*" that provide cash transfers to low-income families with kids at school. Later on in President Lula's government (2003-10), some of those cash transfers programs were unified in a single program named "*bolsa-família".*

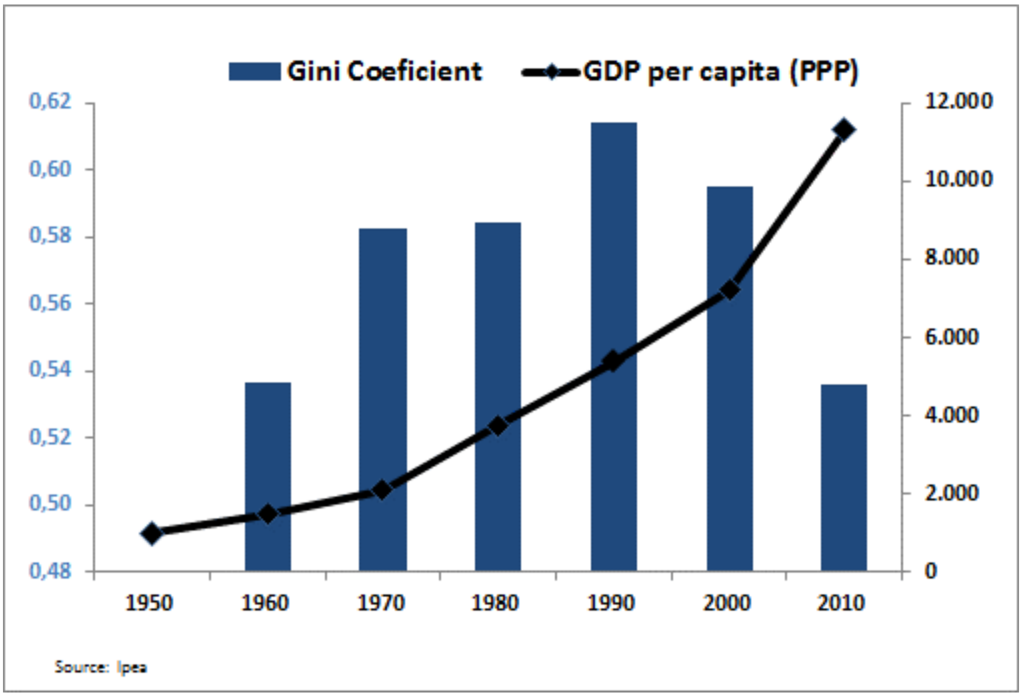
The severe economic crisis of 2002 was met by a surprisingly orthodox economic policy in Lula´s first administration. The government focused on macroeconomic stability and promoted several market-oriented reforms in the credit and capital markets.

Available evidence suggests these reforms have successfully improved market efficiency and have led to a fast credit expansion. Microeconomic reforms played a central role in stimulating the formalization of the economy, granting firms access to capital markets and promoting the emergence of the new middle class. Furthermore, the government focused on the expansion of social policies that were initiated under Cardoso administration.

The result of this broad set of structural reforms was a rebound of investment, productivity gains[30] and improvement in income distribution, as displayed in Chart 3.[31]

[30] See Lisboa and Pessoa (2012) and Veloso, Vilella and Giambiagi (2008) for a survey on the evidence of impacts of the institutional reforms in productivity and growth during this period.
[31] For a very complete analysis of the evolution of income distribution in Brazil in the last decades, see Barros, Foguel and Ulyssea (2007a).

**Chart 3**




Re-democratization led to an expansion of government transfers, as government benefits were granted to new social groups that had been less vocal in the political arena and had not received benefits in the past. Government budget allocations to social spending has increased since the late 1980s, and increased further in the 2000s. Social spending did help reduce income inequality in the first half of 2000s. The Gini index dropped 1.2% per year between 2001 and 2005 and income from the 20% poorest grew 5 percentage points above average income. Barros, Carvalho e Franco (2007b) estimates that half of inequality reduction derived from non-labor income.[32]

Aside from the focus on social policies, democracy was also important for the promotion of solid economic reforms. Surprisingly, some economic reforms of the 1960s and early 2000s were quite similar, including liberal, market-oriented and pro-growth reforms as well as institutional reforms designed to provide adequate regulations similar to the ones observed in developed economies. But the process was different. Reforms under democracy require

[32] Barros, Carvalho and Franco (2007) and Barros, Carvalho, Franco and Mendoça (2007) analyses the reduction of income inequality and provides estimates on the impact of government policies on income inequality. Barros, Fogel and Ulyssea (2007b) summarize the results.

negotiations and evolve more slowly. Still, they have proved to be more solid and resilient, being a natural political development rather than a response to a crisis.

The most important example of successful reform is the consolidation of the fiscal regime. In the 1960s, fiscal stability was always temporary. But in the 1990s, social demand for low inflation required fiscal discipline. The latter was implemented via a broad set of instruments, including privatization, renegotiation and consolidation of state public debt, (partial) social security reform, introduction of primary fiscal surplus rules for the federal government and the creation of the Fiscal Responsibility Law that restrains fiscal policy at all government levels.

Another example would be central bank autonomy. Under dictatorship, the central bank was legally established in 1964, but single-handedly dismissed in 1968 by the president. On contrast, under democracy, autonomy to the central bank has not been granted, but the monetary authority appears independent *de facto*, which is an essential element for the inflation target regime, established in 1999.

More recently, the mood has changed again. During Lula's second administration, economic policy slowly moved from the path initiated in Fernando Henrique Cardoso administration and back towards the old National Developmentism. That change became particularly clear after the global crisis of 2008.

Old habits die hard and government reaction to the crises, as in the mid-1970s, has been increasing intervention and the resuscitation of old rent-seeking mechanisms. Market distortions and transfer mechanisms have been recently reintroduced, such as tax incentives and protection to selected sectors and groups. Monetary transfers proliferated, as democratization meant new interest groups being eligible for government policies, many of them hasty and without clear diagnoses or monitoring of results. State banks credit concessions increased significantly in the last six years in order to finance private sector investment. BNDES credit alone become close to 11% of GDP in this decade. It was government, a larger part of society, belief that by restoring old incentives the country would be able to overcome the difficult external scenario. Six years later, the economic outcome has frustrated several analysts and government officers.

Total factor productivity and commodity prices were the main drivers of economic growth in Lula's government. Since the external crises of 2009, productivity growth has been reduced as well as economic growth. The introduction of several market distortions, the uncertainty about economic policy and government commitment to contracts lead to a more volatile macroeconomic environment.

Fiscal policy was relaxed and monetary policy was slow to react to a higher inflation, though very far from the levels observed in last century, while economic growth disappoints. The backdrop of macroeconomic deterioration adds to the failure of government agencies to deliver acceptable quality of public services, despite the high tax burden.

The low quality of public services is at the center of the debate in Brazil today. Tax burden is high and quality of spending is low. This backdrop is mirrored in the low position of Brazil in global ranking for government effectiveness, even taking into account spending-to-GDP ratio. The low effectiveness of government policies turns out to reinforce rent-seeking pattern of social policies, as the government looks for shortcuts to compensate the poor.[33]

Society has reacted intensely to these threats to what had become the status quo, surprising analysts and politicians. Social unrest, reflected in above 700 protests in more than 300 cities in June 2013, suggests that government needs to resume pro-growth reforms, paralyzed since the middle of last decade, and to improve the effectiveness of government policies in order to reconcile social demands for a better quality of public services and fiscal discipline.

Seeds of a legitimacy crisis brewing might be a reflection of government failure to understand and deliver society demands, against a backdrop of a political system that needs reforms to improve social representation.

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[33] We thank to Marcos José Mendes for this contribution, including the term "arbiter of income transfer" to qualify government social policy.

Democracy and rent seeking have come into inevitable conflict. The widespread concession of special treatments, tax breaks, subsidized loans and economic distortions reduces efficiency and economic growth and angers the public. There is a sense of frustration with public policy and the very modest economic recovering after a few years of low growth.

## 6 - Evolution of education

One important benefit of democracy was the increase of public investment in education, as the 1988 constitution established universal access to education. Rising female participation in the labor market and in the political scene was one driver for this shift in the economic agenda since the 1980s.

Since the middle of last century there is a large evidence of the impact of education on income and growth.[34] Furthermore, in an impressive sequence of studies, Langoni (1973, 1974) showed the significant importance of education in explaining a large share of Brazilian high-income inequality at that time.[35]

Despite the evidence, education was not a priority for most of the twentieth century. Mass education played no role in National Developmentalism. Industrialization was understood as the outcome of capital accumulation and labor, regardless its quality.[36] Knowledge was required only to the extent that it provided access to new technologies, and the priorities of the investment in education were universities and R&D.[37]

Government spending on education had been historically low compared with other developing countries, resulting in higher illiteracy ratios and low labor productivity. In the 1950s public expenditure in education amounted to

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[34] Aghion and Dourlaf (2009).

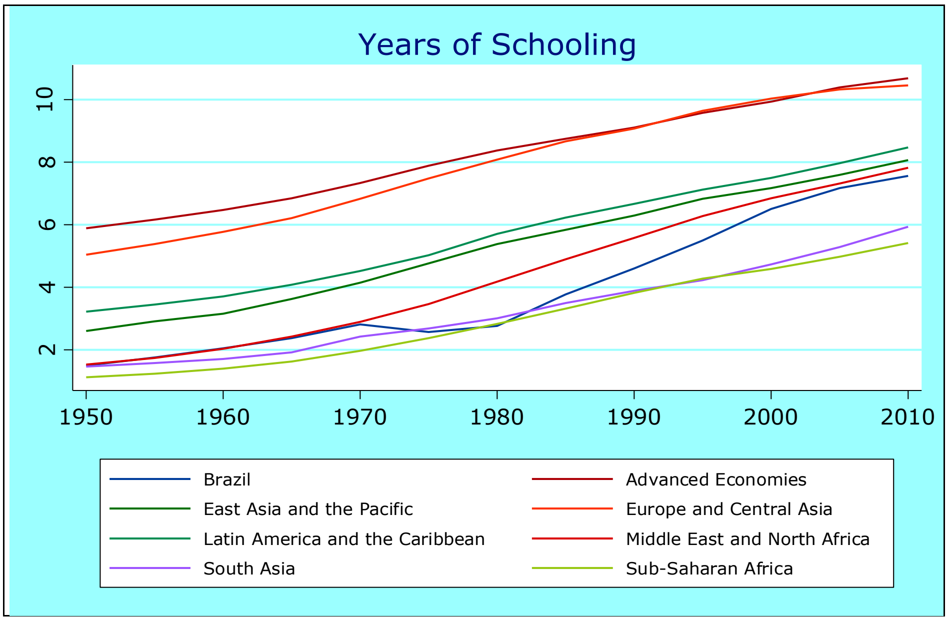
[35] At first, Langoni (1974) decomposed the main determinants of the rate of return on education and alternative sectors investments. He showed that the highest rate of return was in the first years of education. Later, Langoni (1973) studied the main determinants of income inequality and concluded that education explained a large part of it.

[36] For the lack of relevance of education on the economic debate at that time, see Bielschowsky (1988) where, despite its comprehensible analysis of the economic though of the time, the theme is barely discussed. For a further discussion of the evidence, see Pessoa (2008).

[37] For some of the consequences of this approach, see Schwartzman (2011).

1.4% of GDP, fluctuating around 2.7% during 1965-1985.[38] According to Pessoa (2008), in the 1950s, 6 out of 10 children aged 7 to 14 were out of school. Years of low concern with public education left their marks. Chart 4 shows the poor evolution of education in Brazil.

**Chart 4**




Source: Barro and Lee (2012)

Under democracy, government spending on education climbed to close to 3.8% of GDP in 1990, accelerating to 4.5% in 2005 and reaching 5.7% in 2009, which compares to 5.8% of GDP in OECD countries. As a share to total public spending, expenditures in education accounted for 16.8% in Brazil versus 13% in OCDE countries, ranging from less than 10% in the Czech Republic, Italy, Japan and the Slovak Republic, to more than 19% in Chile, Mexico and New Zealand. These figures put Brazil in a more favorable position, at least in terms of spending.

[38] For a survey of the debate on education and income inequality, see Lisboa and Menezes-Filho (2001).

**Table 1: Public expenditure on education**

| | % of total public expenditure | | | | % of GDP | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 2000 | 2005 | 2009 | 1995 | 2000 | 2005 | 2009 |
| OECD | 11.7 | 12.6 | 13 | 13 | 5.3 | 5.2 | 5.3 | 5.8 |
| EU21 | 10.4 | 11.4 | 11.8 | 11.5 | 5.3 | 5.1 | 5.3 | 5.8 |
| Brazil | 11.2 | 10.5 | 14.5 | 16.8 | 3.9 | 3.5 | 4.5 | 5.7 |

Source: OECD (Education at a Glance, 2012)

Democracy, therefore, may have led to a more transparent and collectively decided transfer mechanism, one that is fully accounted in government budget and subject to social scrutiny. That means that democracy may have led to the development of mechanisms more similar to the ones observed in developed economies.

Despite the increase in education investment, Brazil has not reaped the rewards in terms of closing the gap to successful stories in education, like Korea or even Chile. The catch up in terms of years of schooling is still yet to be seen. Moreover, there has been a lot of questioning on the quality of spending. The performance of Brazilian students in international evaluation lags far behind peer countries.

From this perspective, Brazil's challenge is to improve the quality of spending rather than increasing the budget for education. The priority in the last couple of decades was to provide universal access to education. Now it is time to move forward and provide egalitarian access to good quality education.

A major challenge for public policy is to understand the reasons for such a poor outcome of public spending on education, its incentives and rules. Why do our schools perform so badly and pedagogical tools seem to be so ineffective? How should incentives and rules change in other to foster a more efficient use of public resources? These seem to be the challenges ahead.

## 7 –Rent-Seeking Mechanisms and Democracy

Government intervention via rent-seeking mechanisms is broadly accepted by society, and at the root of this belief might be the heritage of high inequality since the colonial period. Rent-seeking is seen not as transitory second-best policy, but as a strategic tool to promote growth.

Following Olson (1971), one important reason for the survival of such a perverse mechanism has been the lack of transparency of rent-seeking's costs to the society, which are in turn diffused. Benefits, on the other hand, are concentrated and very visible for the ones who receive them. Aggravating factors are the limited political participation, as well as those government agencies that provide privileges and benefits to selected groups away from public scrutiny. Diffused costs and concentrated benefits are at the core of the persistence of rent-seeking mechanisms.

Democracy was built and shaped under this belief as well as this government modus operandi. As long as new groups appear in the political arena, claims for more equality have been met with more rent-seeking policies, which work as shortcuts to meet social demands.

Rent-seeking in Brazil manifests itself in several ways. We divide them in four main groups. First, there is a very complex system of tax and transfers, characterized by several rules and exemptions that mask the beneficiaries of privileges. Second, there are mandatory tax-transfers mechanisms that do not go through government budget. Third, several cross-subsidies, via prices control and forced allocations of funds, provide specific benefits under hidden mechanisms. Lastly, there are trade and non-trade barriers that limit competition at the expense of consumers, impacted by higher prices and worse quality of goods. They all contradict the ideal solution of direct transfers included in government budget.

In the following sub-sections, we describe a few of these mechanisms.

### 7.1 Rent-seeking: Taxes and transfers

Large government does not necessarily mean inefficiency. In many developed economies, at least until the end of the last century, as long as there was a transparent process in which tax-transfers mechanisms were widely debated and evaluated, they were accepted. In many countries, there is a permanent concern with the monitoring of their impact, leading to frequent reforms.[39]

The effectiveness of the fiscal policy in promoting long-term growth depends on the quality of spending and the complexity of the tax system, and Brazil fails on both fronts.[40] Rent-seeking weakens the effectiveness of fiscal policy, as it reduces the resources available for investment and social spending and produces a distortive tax system.

Historically, spending on education, healthcare and income distribution had been rather low in Brazil, even in comparison to other developing countries, and not entirely subject to democratic scrutiny.[41] The tax burden was also low, hovering around 10% of GDP up to the 1940s and increasing to 20% in the 1970s, as government widened the intervention in the economy. Once inflation stabilized and the expansion of government transfers increased, it scaled up to 25% of GDP in the 1990s. Government spending in Brazil reached 40% of GDP in 2012, according to the IMF, while the tax burden was close to 37%, as displayed in Chart 5.[42]

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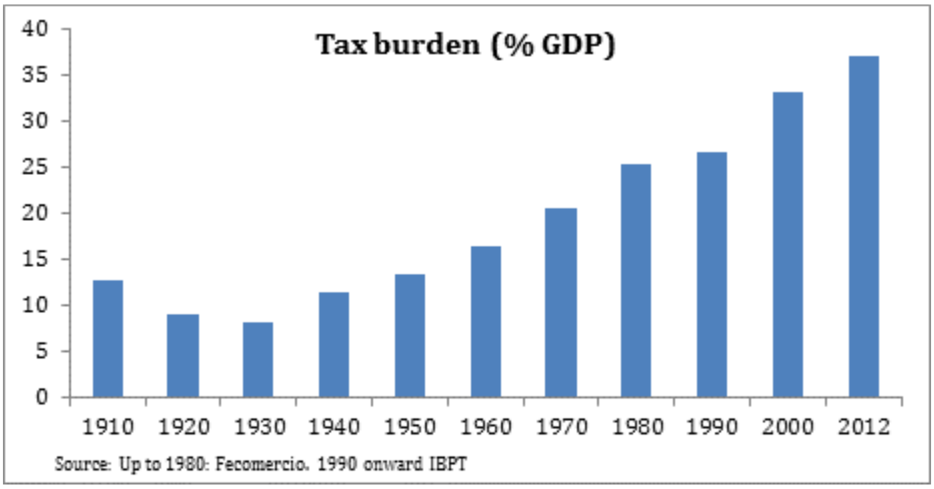
[39] Lindert (2004) provides an extensive quantitative analysis on this subject as well as the different behavior of labor market in these economies. Since 1960s, social spending has moved increasingly towards to pensions, which has led to debates of their net economic costs. For a recent analysis of tax reforms in developed countries in the last two decades and their concern on growth incentives, see Brys, Mattews and Owens (2011).

[40] Lindert (2004) emphasizes the importance of transparency and democratic controls of taxes and government transfers in developed economies, where several reforms and controls were implemented in order to reduce incentives contrary to economic activity. Brys, Mattews and Owens (2011) discuss tax reforms in OECD countries in the last 30 years and their motivation.

[41] Ministério da Fazenda (2003) compares tax and transfers to families in Brazil and other countries and shows that in the second income inequality is deeply reduced by government transfers, contrarily to the first.

[42] The level of complexity leads to many methodological debates in Brazil on how to evaluate the tax burden. In an impressive and complete work, Afonso, Soares e Castro (2013) describes Brazil's complex tax system.

**Chart 5**




Comparing these figures to countries with similar income per capita, one can see that Brazil has become a higher-spending, higher-taxation country.

**Table 2**

Total Tax Revenue (% GDP) 2012

| | |
|---|---|
| Brazil | 37.2 |
| Argentina | 40.3 |
| Chile | 23.9 |
| China | 22.6 |
| India | 19.1 |
| Israel | 38.9 |
| Korea | 23.3 |
| Mexico | 23.6 |
| Turkey | 34.7 |
| South Africa | 27.9 |

Source: IMF.

According to the Global Competitiveness Report, 2012-2013, Brazil ranked last in a sample of 144 countries in the item Extent and Effect of Taxation, and 131th on total tax rate, an item intended to measure total taxes incident over production and labor.

The complexity of Brazilian tax rules is overwhelming. The tax system embeds a myriad of rules, exceptions and exemptions, which cause excessive bureaucracy and distortions that hurt growth.[43] From 1988, when Brazil promulgated its new constitution, to 2011, there were close to 156,000 new norms - including 6 constitutional amendments, more than 4700 new laws, 1162 provisionary measures - and more than 130,000 complementary norms. These numbers refer to federal government only.[44] The outcome is a complex system with several different taxes rules for specific sectors and products, and several compensation schemes for different taxes paid by same company. According to 2012´s report of the federal court of auditors ("Tribunal de Contas da União"), federal tax exemptions amounted to R$215.5 billion including credit benefits provided by BNDES, which stands for 5% of GDP.

Re-democratization helped to increase the distribution of the tax revenue among states.[45]Democracy also increased meaningfully monetary transfers to low-income people, like pensions to agricultural workers and other informal workers, and several cash transfers programs to low-income families in the second half of the 1990s. Later, in the first half of 2000s, some of those programs were unified and extended under the "*Bolsa-Família*"[46], a moderately successful program that amounted to 0.5% of GDP in 2012 and helped to reduce income inequality.

Despite the success of some targeted social policies, total social spending still fails to improve income distribution in comparison to other countries. According to Immervoll et all (2009), the Brazilian government spends more than two-thirds of tax revenue on social programs, which compares to OECD averages. Nevertheless, Brazil still fails significantly to reduce income inequality and poverty as observed in more developed countries. The main reason for that is the public social security system, due to its high concentration on a relatively small group of beneficiaries.[47] Pensions account for 85% of total cash transfers

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[43] For a complete, and for that matter, impressive description of Brazilian complex tax rules, see Afonso, Soares and Castro (2013).
[44] Amaral et al. (2012).
[45] See Afonso, Soares and Castro (2013, pp. 77).
[46] For a government discussion of income inequality and the benefits of such policies, see Ministério da Fazenda (2003).
[47] Non-pension benefits display concentration indices comparable to those of some EU countries. Nevertheless, they represent only 1.5% of household disposable income versus around 15% in EU countries, so that their equalizing power is limited and far from enough to compensate pension benefits.

to households (about 11% of GDP), which in turn represent almost one quarter of household disposable income. This percentage is above the OECD average, despite Brazil's much younger population, while benefits are too concentrated, with ratios far above the EU countries.[48]

Souza (2012) reached a more pessimistic result when analyzing the net impact of government actions on income distribution. Using 2008-09 data, his study shows that government intervention worsens income distribution, as wealthier public servants are the beneficiaries of more generous social security. Whereas government action explains one third of income inequality in Brazil, one fifth stems from pensions. The author mentions that this magnitude could be underestimated as it includes progressive[49] direct taxes and contributions, but it does not include indirect taxes, which are regressive.

In line with those findings, Afonso, Soares and Castro (2013) compare the Index of Human Development (IHD) of several countries against their respective tax burden and show that Brazil lags behind.

It is worth mentioning another important example of rent seeking: the economic area of Manaus (*Zona Franca de Manaus*, ZFM).[50] The ZFM contains about 600 industries, mainly in electronics and chemicals, and employs 400 thousand workers. ZFM was formally created in 1967, with a broad set of tax breaks aiming at promoting regional development. Incentives were supposed to end by 1997. Nevertheless, they have been continuously renewed since then, and in 2003 government postponed their end to 2023.

Fiscal incentives are estimated in at least R$24 billion for 2011 or 0.6% of GDP, as this amount does not comprise other municipal (lower property tax) and state incentives (lower value added tax on goods produced in other regions and sold at ZFM).

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[48] For similar results and a further analysis of the Brazilian pension system design and its impact on government transfers, see Rocha and Caetano (2008).

[49]"Tax progressity" describes the way rate progresses from low to high income or expenditure, where the average tax rate is less than the marginal tax rate. Progressive taxes attempt to reduce the tax incidence of people with a lower ability-to-pay, as they shift the incidence increasingly to those with a higher ability-to-pay.

[50] This session is based on Miranda (2013).

Companies in the ZFM operate like "maquiladoras", basically assembling and packaging products, generating little value added and requiring imports of inputs far above country's average. Furthermore, ZFM looks like an enclave without strong ties with country's production chain. ZFM survives based upon captive domestic demand as trade barriers protect local production. The outcome in terms of exports is disappointing, when contrasted to the Mexican experience. Exports stand for less than 3% of companies' turnover.

The companies that are part of the ZFM have no incentives to invest, as they depend on permanent government protection. The ZFM has persisted, despite its failure to promote regional development and reduce social inequality, at the expense of the society.

### 7.2 Rent-seeking: Compulsory money transfers outside government budget

A remarkable feature of Brazilian rent-seeking is the government's ability to create tax-like contributions on individuals and firms, and to transfer resources directly to special interest groups. These mechanisms do not go through the government budget and are not subject to yearly congress discussion or society scrutiny.

An example is "Sistema S", a pseudo-tax which takes the form of a compulsory contribution on a given firms' payroll that is directly transferred to 11 private institutions which support labor force education, cultural events and other things. In 2010, funds allocated to "Sistema S" amounted at least to 0.3% of GDP, according to Afonso, Soares e Castro (2013).

Another example is workers' mandatory savings, called FGTS, which collected close to 1.7% of GDP in 2010, according to the same authors. Registered workers must collect per year an amount equivalent to a monthly wage, as compulsory saving, which is kept in a fund managed by a government agency. These resources are used as funding for investments in several areas. Workers can only use these resources when retiring or under specific circumstances, like upon termination of employment or for financing housing acquisition. This fund pays interest below market rate.

It is interesting to notice that as informality has been historically high in Brazil, most individuals are not under government supposed protection. Therefore, FGTS as well as "Sistema S" are usually seen as benefits to formal workers and an advantage over informal jobs rather than a burden on wages. There is no transparent mechanism to evaluate the cost-benefit of those instruments or their opportunity cost.

### 7.3 Rent-seeking: Cross-subsidies

The phenomena of cross-subsidy is common. In areas as widespread as the regulation of the health insurance market, the supply of infrastructure services and even access to cultural goods there are legally introduced distortions that provide benefits to small groups, without transparency, at the expense of society. In several cases, relative prices are moved away from their efficient level and negative incentives are introduced.

The most peculiar ones are discounts on prices of cultural events. Prices vary according to age and occupation. Students and elderly are entitled to half price at the expense of other individuals who pay higher prices. Half tickets have been increasingly allowed to a large number of groups, including people who donate blood transfusions, to illustrate the extension of the benefit.

Cross-subsidies also weigh on the credit market, with many negative implications in terms of resources allocations and effectiveness of the monetary policy. Government intervention in the financial market is very peculiar in Brazil. From independence to late twentieth century, many public banks were created, evolving to a large network of public banks, federal and state ones. It was not a fully successful history, as those banks were often used to finance private and public sectors under questionable conditions. Many of them, like Banco do Brasil, have gone bankrupt a few times, as in the severe crisis of local states public banks in late 1990s, which resulted in losses close to 6% of GDP, according to Lundberg (2011). The arbitrary use of public banks, their social costs and macroeconomic impacts are subjects yet to be detailed in Brazil economic history.

Financial markets are also affected by cross-subsidies in private sector loans.[51] Regulations severely restrict the amount of deposits available for funding non-earmarked credit operations. Reserve requirements on demand deposits are close to 50% against less than 10% in most countries. Besides, there are several earmarked loans, charging interest rate below the market, which, excluding BNDES loans, stand for 20% of credit outstanding (as of 2012). Non-earmarked loans charge much higher interest rates to consumers, in part for compensating the subsidy embedded on earmarked operations. In 2012, spreads on the former reached 20% versus 3.5% of the latter.

The state bank BNDES is included in the set of distortions in the financial market. It is also an example of how institutions survive, adapting to new circumstances, and in this case, reinforcing the rent-seeking scheme. Established in 1952, the BNDE (BNDES since 1982) initially focused on developing infrastructure. Later, in the 1960s and 1970s, BNDE widened its role by becoming a majority shareholder in many companies.

Over the 1970s, BNDE shifted to financing private companies. It used new instruments, financing machinery acquisitions, serving as guarantor in credit operations abroad and investing directly in the equity of domestic companies. In 1982, it created BNDESPAR, a private investment arm, to manage those holdings. In the 1990s privatization program, BNDES played a central role. Aside from being an operational agent, it provided financing for the buyers in some of the transactions and purchased minority stakes through BNDESPAR, aiming at attracting private players to the auctions.

BNDES remained strategically important even after the liberalization and privatization wave of the 1990s. During Lula's government, BNDES was involved in several large-scale operations aiming at building "national champions", large Brazilian companies that were build up to compete against international companies in world market.

Time has passed, capital markets in Brazil have developed significantly,

[51] Private loans in Brazil have always been subject to several mechanism and price interventions. In late 1980s, for example, inflation correction of mortgage loans was limited to wage increases, which resulted in losses above 4% of GDP (Lundberg, 2011).

but BNDES has persisted and it has become even larger. It has changed its role over time, adapting finance mechanisms and its funding sources as well. BNDES has clearly deviated from its role to finance projects with high social return that would not be funded otherwise.

Since the disruption of the global crisis in 2008, BNDES loans have been a supposedly anti-cyclical tool. Loans increased dramatically reaching 11% of GDP in the end of 2012 from around 6% prior to the crisis, counting on enhanced cash by the treasury. According to the federal court of auditors ("Tribunal de Contas da União"), implicit subsidy of to the BNDES would have totaled BRL22.8 billion in 2011 (around USD10 billion). Additionally, BNDES has been lately a source of resources to the treasury via anticipation of dividends payment. As a result, Basel index has been decreasing, reaching 14.5% in March 2013 from 20.6% in the end of 2011.

The BNDES System amounts to USD333 billion of assets versus USD338 billion of the World Bank. BNDES is the third largest development bank in the world, following China Development Bank (USD751 billion) and Germany´s Kredintaltanlt für Weidarufban (USD596 billion).

BNDES does not comply with the key design attributes for a successful industrial policy defended by Rodrik (2007), which are "embeddedness", carrots-and-sticks, and accountability. Government makes top-down decisions on sectors to be protected with no adequate involvement of the private sector. BNDES encourages investments in nontraditional areas (the carrot), but fails to weed out unsuccessful projects (the stick); and public does not have access to operations´ performance. There is no transparency on BNDES operations. No available data on total subsidies provided, benefited companies or sectors and the cost-benefit of policies. Furthermore, the evaluation of the outcome of BNDES investment decisions is also unavailable.

When it comes to assess the impact of BNDES in the economy, conclusions are disappointing. According to Musacchio and Lazzarini findings, BNDES has been picking "winners" but neither invests in capital-intensive projects nor in projects that improve their performance. Regarding loans, the only significant impact is the reduction on firms' financial expenses, without any consistent effect in terms of investment or performance. Moreover, the authors point that firms benefited by BNDES and firms donators to elected political candidates are correlated.

Another criticism is the distortions generated by the bank's funding model. As discussed by Musacchio and Lazzarini (2013), BNDES funding changed over time. From government transfers and monetary deposits, with inflationary implications, in the very beginning, to payroll taxes intended to finance unemployment insurance program (FAT), consolidated in 1990, whereas BNDES would pay in return the so-called federal long-term interest rate (TJLP), below central bank's interest rate. From the 1980s to 2008, BNDES relied significantly on retained earnings, basically the return on investments in securities using BNDESPAR. More recently, since 2009, a huge amount of funding has been coming from Treasury transfers via public debt issuance.

Lastly, BNDES role changed over time without society participation on this decision, even indirectly via congress, because BNDES does not enter in the government budget. Society has no clarity on cost-benefit of BNDES policies, because there is no transparency on its policy. Society acquaintance of BNDES activities remains basically restricted to its support to cultural activities, disclosed via institutional marketing, which in the end masks its impact in the economy.

### 7.4 Rent-seeking: Trade protectionism

There is an additional mechanism of rent-seeking: trade protectionism to specific sectors, characterized by unusual higher import tariffs and non-tariffs barriers in comparison to other countries, which are also complex and, in several cases, severely limit foreign products access to the Brazilian market.[52]

After World War II, the imports substitution model as a strategy to promote the industrialization of the country resulted in a reduction in trade flows. Decades of protectionism took its toll in terms of low productivity gains

[52] For an example, see Carrasco and Mello (2013).

and poor external competitiveness of Brazilian manufacturing, which in turn has been frequently used as an excuse for keeping barriers.

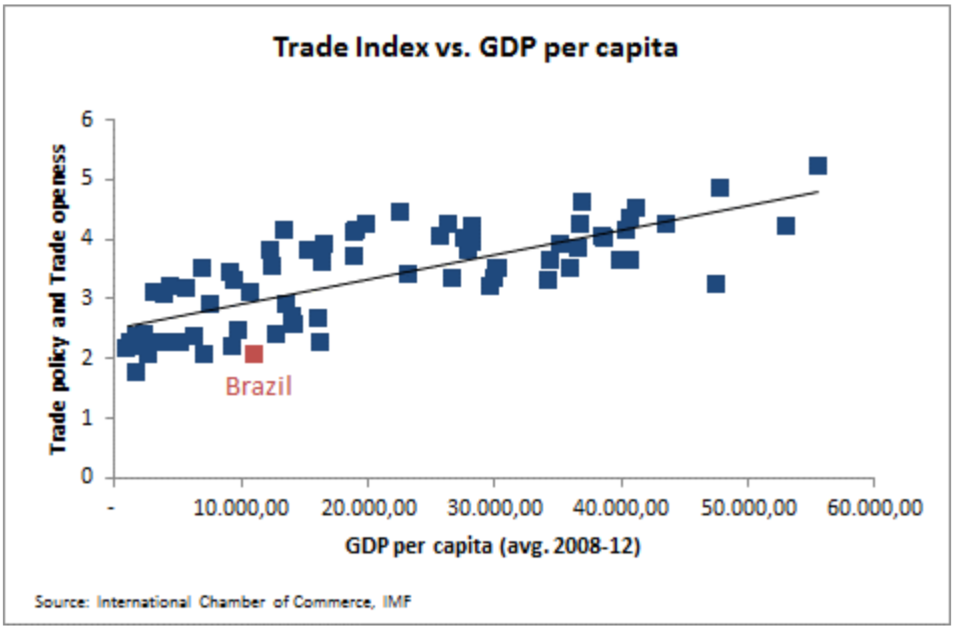
The collapse of this growth model in the 1980s resulted in efforts to open the economy to trade, under democracy. Nevertheless, Brazil still remains a very closed economy, with a complex structure of tariffs and non-tariffs barriers, which produces income transfers from buyers, consumers or other firms, to the protected sectors.[53] Nominal tariffs are high in Brazil in comparison to other countries and they have a wide dispersion, ranging from close to zero to 35% in late 2000s (Moreira, forthcoming). Effective tariffs have an even wider dispersion, ranging from close to -5% to an impressive 180% in 2005, having increased since the late 1990s. Furthermore, trade protection has steadily increased since earlier 2000.[54]

Brazil stands at the group of the most closed economies in the global ranking in terms of trade openness and trade policy, measured by the level and complexity of tariffs, non-tariffs barriers, and efficiency of import procedures, as shown in Chart 6. Small trade openness in itself does not argue against Brazil, because large countries tend to be more closed. Brazilian experience distinguishes itself due to significant trade barriers adopted.

[53] Brazil relies on many technical requirements to restrict competition from abroad. Technical norms that are very distinct from the ones used in other countries and bureaucratic maneuvers that make it impossible to import some goods. Those barriers end up with higher costs for local consumers. For an example of such procedures and their costs, see Bacha (2012).

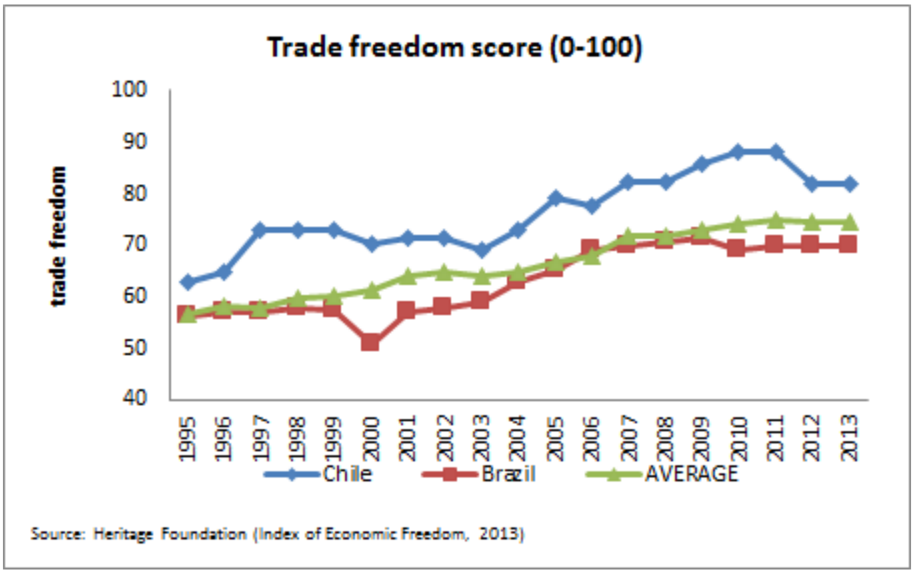
[54] Moreira (forthcoming) summarizes several data on Brazil trade protections. Castillho, Ruiz and Melo (s.d.) provides a careful analysis of Brazil evolution of effective tariffs on earlier 2000s.

**Chart 6**




Moreover, as displayed in Chart 7, the country has apparently worsened trading conditions lately, in the aftermath of the global crisis disrupted in 2008, with deterioration in the Index of Economic Freedom, after important improvement last decade, even in comparison to Chile, an economy far more dependent on trade than Brazil.

**Chart 7**



Protectionism has barely been a subject of society debate in Brazil, which is aligned to some findings in the literature that shows that the relation between democracy and protectionism is not straightforward and depends on country endowments. O'Rourke and Taylor (2006) show that in poorer regions such as Latin America, low capital-labor ratios along with high-land-labor ratios led to raised tariffs, contrasting to the US experience, as the country has high capital-labor ratio.[55]

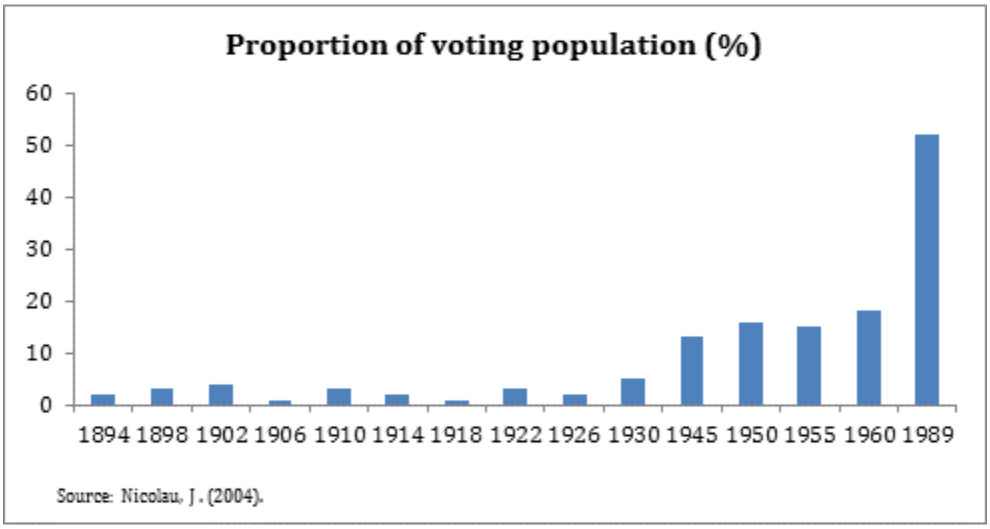
## 8 – Democracy indicators: where does Brazil stand?

In 1824, the first Brazilian constitution established limited suffrage. Voting was restricted by wealth and literacy requirements. This backdrop changed slowly under the Republic. The mandatory and secret vote was established only in 1934 amid significant political pressure. The female vote dates back to 1932. The illiterate vote appeared only in 1988.

The proportion of voting population was negligible, around 2% up to 1934, climbing to only 18% in the 60s. Under the re-democratization, it crossed 50% of the population (Chart 8). On contrast, in the US and Canada, the proportion of the population voting was around 16% in 1880 and 40% already in 1940.

[55] According to the authors, countries in the New World with high land-labor ratios, democratization should have been associated to higher tariffs, except those richer, such as the United States, with high capital-labor ratios muting this effect significantly.

**Chart 8**



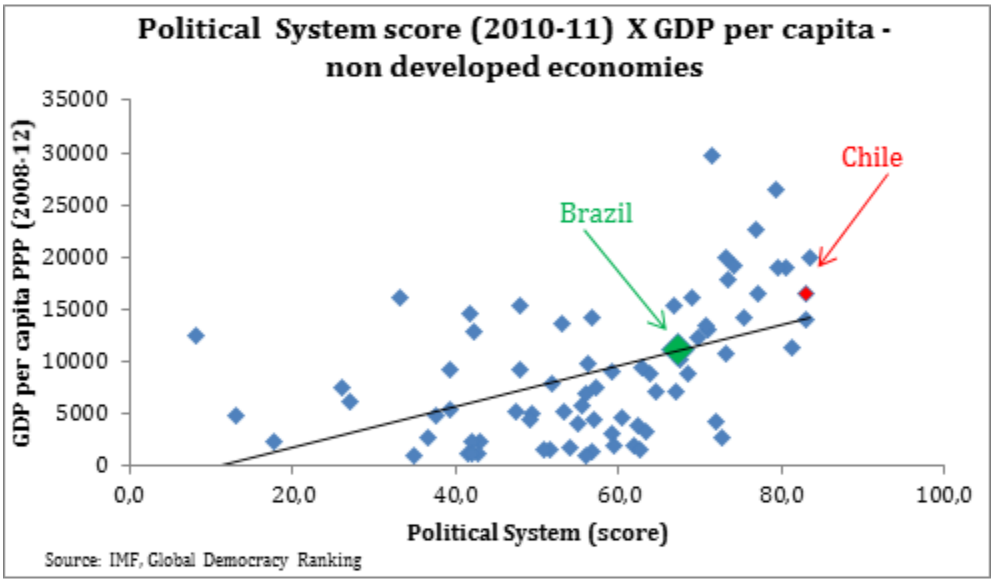

Democracy, however, should not be only measured by the proportion of the voting population. There are several other relevant variables to evaluate the quality of democratic institutions, such as social participation, civil rights and freedom of expression.

The construction of democracy rankings is significantly complex, especially because it should encompass several institutional aspects. The next step, as difficult as the first one, is to identify possible indicators to compose the index. That being said, conclusions from those indicators should be taken with a grain of salt.

There are few democracy rating indices available and the range is not large. The Global Democracy Ranking tries to measure the quality of democracy via the degree of freedom and some other characteristics of the political system, and the performance of non-political dimensions. We focus here on the political system, which would be the closest gauge for democratic institutions, leaving aside other indicators, because they are more linked to economic and social indicators, in our opinion. The sub-index called Political System comprises: political rights (25%), civil liberties (25%), gender gap (25%), press freedom (10%), corruption perceptions (10%), change of the head of government in the last 13 years (2.5%) and political party change of the head of government in the last 13 years (2.5%).

Brazil's Political System score against its GDP per capita can be considered today an intermediary position when compared to other non-developed countries (Chart 9). In other words, both variables look consistent to each other. Nevertheless, Brazil is far away from Chile, which stands at the "top one" position in the ranking in terms of political system. This striking gap highlights the necessity to pursue the improvement of democratic and pro-growth institutions in Brazil.

**Chart 9**




The World Bank Governance Indicators helps to shed a light on this subject. The indicator comprises six dimensions: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption.[56]

Brazil performance has not changed meaningfully since 1996, when the study starts. One can see no striking improvement in all dimensions, except for some upgrade in "Voice and Accountability", which measures citizens' ability to participate in selecting their government, as well as freedom of expression (Chart 10).

[56] The six aggregate indicators are based on 30 underlying data sources' reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide.

On the bleak side, “Regulatory Quality”, which measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development, has worsened since then (Chart 11).

**Chart 10**

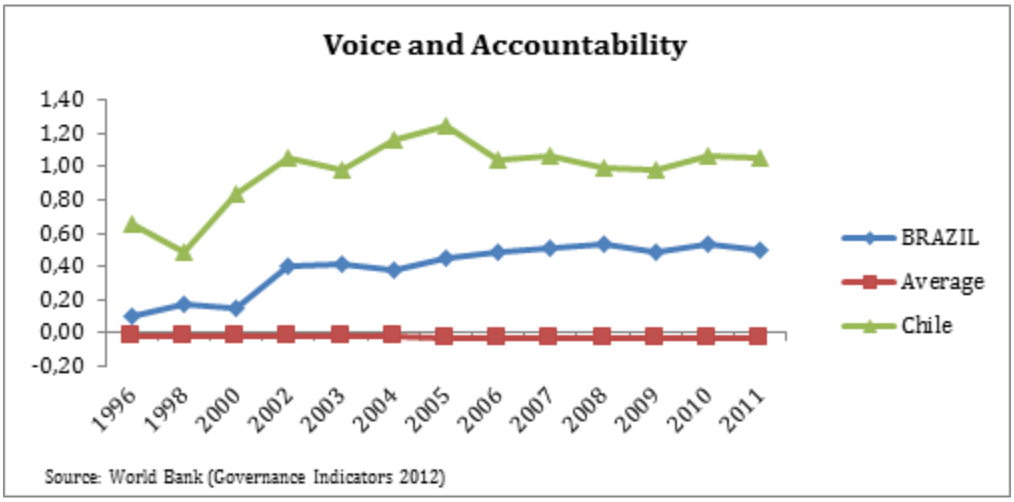
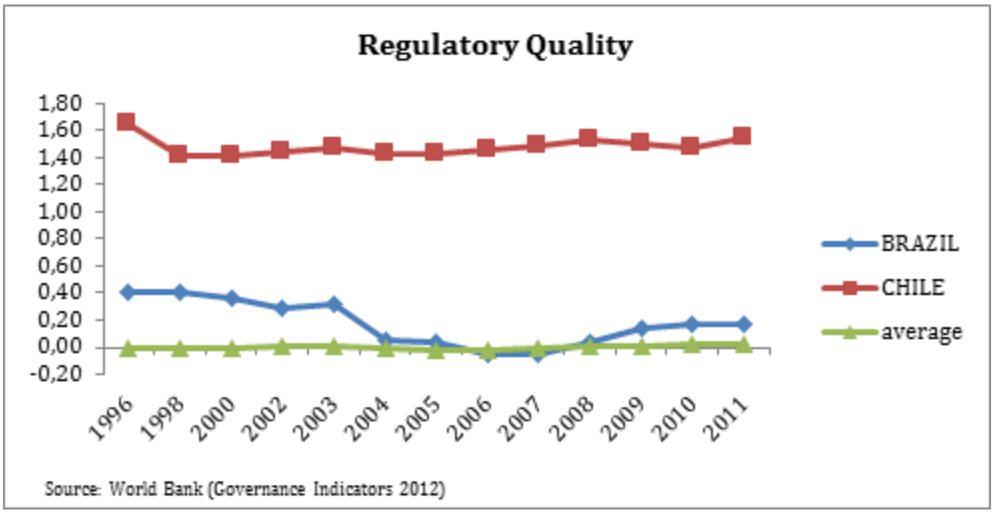



**Chart 11**




“Government Effectiveness”, which measures the quality of public services and the degree of its independence from political pressures, has remained on sidelines (Chart 12). The dimension “Rule of Law”, which measures the quality of contract enforcement and property rights, has improved lately, but failing to cross the global average (Chart 13).

It is worth mentioning that, for all dimensions, the differential to Chile, which is considered the benchmark for Latin American countries, has not diminished.

The main conclusion is that both countries look more democratic today, in terms of social participation in the political system (“Voice and Accountability”), but Brazil remains sliding in terms of governance indicators, which are related to pro-growth institutions.

**Chart 12**

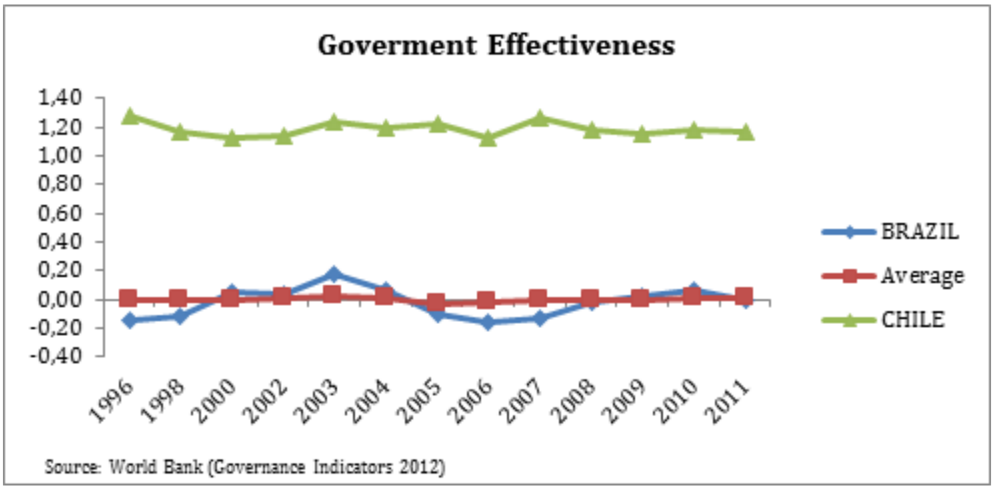
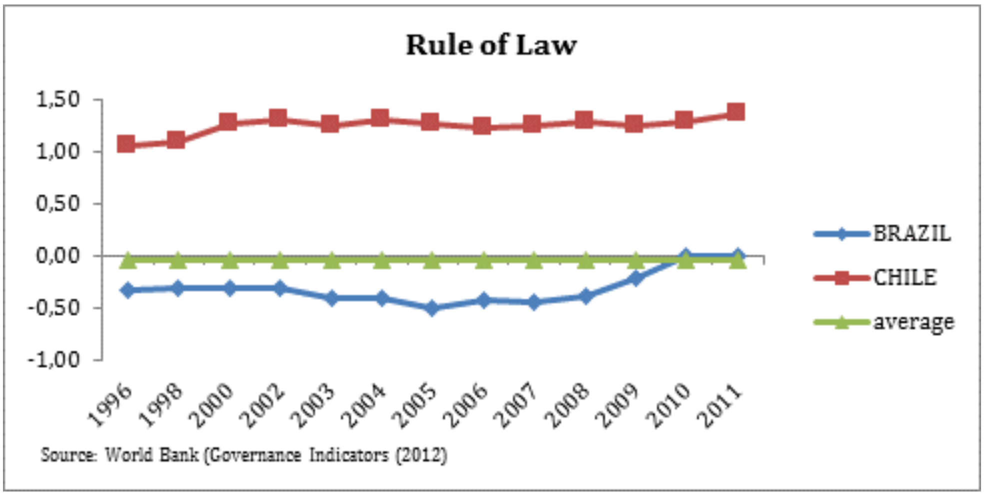



**Chart 13**




One possible interpretation for these figures is that Brazilian democracy is still recent and young and it is yet to be seen whether it could derive into the development and improvement of pro-growth institutions. From this perspective, closing the gap to Chile indicators could be only a matter of time, whereas the seeds for improvement would have been already sowed.

Alternatively, and possibly a more realistic view, is that democracy improved, but it still has a long way to go once a broader concept of democracy is taken into account. Morlino (2011) considers not only (almost) universal adult suffrage, civil rights and civil liberty, but also the absence of political actors able to block or control the arena of political decisions.

Aside from that, judging by Brazil experience, the presence of political actors with veto power might not be the only threat to democratic institutions. The lack of transparency of government policies contributes significantly to weaken democracy, not only due to risks of higher corruption and low government alternation, but also because widespread and opaque rent-seeking policies mean undemocratic economic decisions. Society does not effectively participate in economic decisions and does not take into account the costs and impacts. Rent-seeking institutions are preserved from an encompassing political debate.

## 9 – Concluding remarks

A large government, with several agencies and intervention mechanisms, that mediates and regulates economic and social relations to an extent rarely observed in developed countries, seems to be a distinctive feature of Brazil's economic and political development. We propose the term rent-seeking to summarize society interaction with government agencies in which public policies are supposed to provide specific privileges and benefits, frequently by unusual mechanisms when compared to other countries. It also results in a peculiar political process in which social demands are often decentralized, and in many cases addressed without going through government budget, and their social costs are diffused over society.

This paper addresses four main issues, trying to answer the following questionings.

First, why has a broad system of rent-seeking policies appeared? Extractive institutions and limited political participation seems to be the outcome of colonization period in most of Latin American countries. It resulted, for a large part of Brazil history, in a politically authoritarian regime and an economically interventionist government. The rules of the game in such a society rewards political access to government policies.

Second, why have rent seeking persisted after independence and enlarged significantly during last century? The dominant belief in Brazil held that government economic intervention was essential to overcome underdevelopment. It was its role to coordinate private investment decisions, to provide funds for several projects as well as protections and benefits for selected sectors in order to foster growth. For many years, the project was successful in promoting robust rates of growth and it was progressively enlarged. However, it was also an unstable process in the long run. It led to macroeconomic imbalances and ultimately low productivity growth. After a while, excessive protections and the dissemination of benefits resulted in high social costs, either in the form of inflation, high tax burden and economic distortions eroding efficiency.

Third, why has mass democracy been unable to change this modus operandi of the economic system? Rent-seeking policies are opaque to society. Benefits from government interventions are tangible and result in political vocal groups that oppose withdrawing the benefits and protections. The diffused nature of their costs, however, leads to a fragile opposition to their maintenance. Some of those interventions are present in most developed countries. What distinguishes Brazil is the extension they have assumed.

Brazil has been experiencing a "democratization of privileges." In the last decades, specific benefits and discriminatory policies have been progressively extended to several groups. Benefits from such policies are well perceived but not their economic and social impact. Furthermore, the interests of small groups and popular groups look aligned, though artificially, in many situations, which increase the opposition to reforms. This is the case of reform of public servants.

Any reform proposal faces significant resistance from all society, indistinctly, though they do not affect popular groups.[57]

How could democracy help to promote reforms? In the democratic period, there have been demands to extend benefits for social groups long seen as underrepresented in the political arena. More recently, there have been also demands for improving the quality of public services. Social movements have been challenging current policies and have started to question some concession of privileges and benefits to specific sectors. It is still a young movement, but a surprisingly strong one that, for the first time in many decades, calls for changes in government policies.

Re-democratization has been a game changer. The serious economic crises of the eighties, characterized by severe public deficits, hyperinflation and external crisis, led a decade of low growth and several failed stabilization policies. The severe crisis resulted in several institutional reforms beyond stabilization. Trade barriers were reduced, state owned companies were privatized and quite a few market-oriented reforms were implemented, not without fierce resistance. Ending special privileges and benefits affected several economic sectors and special groups. However, in the end, the reform agenda managed to balanced government budget and to provide the necessary controls to ensure fiscal discipline.

Furthermore, re-democratization also led to an important shift in the social policies and, for the first time in Brazil history, it became the center of government policy debate. Access to public education has been widely enlarged, and several social programs focused on the lower income families have been introduced and public spending.

Brazil experience suggests that democracy might have contributed to the construction of more solid institutions, contrasting to those undertaken during the dictatorship, albeit the pace of adjustments looks slower. Reforms in democratic regimes may be more difficult to negotiate, but they have proved to be more resilient.

[57] We thank to Marcos José Mendes for this contribution.

Demand for public intervention, in an age of low tolerance for inflation and fiscal discipline, has led to a rising tax burden, which reached the impressive mark of 37% of GDP in 2012. Furthermore, reforms were partial and several government intervention mechanisms persisted, such as federal state-owned banks, large trade protections and subsidized loans that are over 30% of the country total credit.

As economic growth resumed in the last decade, the reformist impetus faded and the political pressure for government intervention was reinstated. Public agencies were provided additional resources and instruments to induce specific sectors development. Progressively, government has started a large development plan, ranging from naval industry to oil and gas, aside from several specific sectors. This plan was enlarged after the global crisis of 2008.

There has been a new wave of expansion of old-style mechanisms to expand protection and transfers, especially for the industry. BNDES loans have increased significantly, reaching 11% of GDP. It has also increased its minority equity allocations. Tax breaks have been provided to selected sectors along with growing complexity of the tax system. Tariffs and non-tariffs barriers have been raised to protect selected sectors. As a result, growth has been disappointing, and inflation has risen.

The disappointing economic behavior and a widespread dissatisfaction with government concession of privileges have led to social unrest. Paradoxically, political movements are once again demanding specific benefits. It is not the nature of a strong government intervention that seems to be in dispute, but the ones who should be the beneficiary. Several new groups have introduced new demands whose costs are to be diffused throughout society.

Ending the centrality of rent-seeking in Brazil is essential for increasing investment and growth potential. Local provision of specific privileges and benefits has introduced economic distortions and reduced productivity growth. Transparency seems to be essential to allow democratic institutions to discuss and deliberate over government policies and evaluate their outcome.[58]

[58] For a discussion on some recent setbacks in the institutional framework, see Pessoa (2013).

This paper, hopefully the beginning of a larger research project, summarizes a historical interpretation of Brazilian institutional development and its impacts on several aspects our political and economic model. At this stage of our research, we have provided some evidence that support and exemplified our main argument.

There is still a lot of work to be done, such as collecting all the evidence on the rent-seeking mechanisms, their economic effect and distortions, and assessing the role played by the political process on the development and accountability of the rent-seeking mechanisms.

Systematizing all tax-transfers mechanisms is a crucial first step to a full comprehension of the rent seeking structure, in order to reassess government policies. This is particularly important taking into account the opacity of government policies. This effort will require estimation of non-monetary transfers policies such as subsided credit loans and trade protections, including non-tariffs ones. This is a large task, though a necessary one.

These data could provide inputs for researches on the evolution of policies over time, shifts in their focus as democracy evolved, their outcomes in terms of growth and equality and lessons to be learned.

Several questions regarding the cost-benefit analysis remain unanswered whereas they should be part of democratic deliberations. Social costs and benefits of public policies should be transparent and subject to questioning. The same must be said about distortions caused by public policies that hurt productivity and economic growth. Confrontation of results and expectations is the best way out to economic reforms and evolution.

This is particularly relevant for Brazil at this moment, when fiscal constraints and growing social demands need to be met, requiring reassessment of policies and priorities, according to democratic choices.

Transparency requires institutions that disclose costs and benefits, allowing social accountability. One such institution could be an independent and well-equipped agency responsible for monitoring public policies. Its objective would be to record policies targets and monitor their implementation, rather than approving projects and discussing their merits.

Each new project would have to be submitted to the agency, with clear indication of purposes, expected outcomes and costs. The agency research department could also compare government proposal policies to equivalent ones undertaken abroad. It could summarize best public policies practices in other countries and contribute to policy discussions in Brazil. The agency would be requested to provide information on policies' targets and actual results annually, and the information, available to the budget commission in the Congress, would be publically disclosed. Society must be able to evaluate whether the benefit worth the cost.

A second proposal is that all concession of benefits and privileges must be identified as public transfers and be accounted for in the government budget, including all subsidized loans, transfer to "Sistema S", ZFM and FGTS. Implicit subsidies must be made explicit to society. Those receiving protections and privileges from government must have their accounts disclosed. Society must know the beneficiaries and the results of such policies. This proposal would lead to full accountability.

Privileges, protections and transfers are always desired by those who receive them. Rent seeking creates by itself incentives of self-preservation by interest groups. If individual social cost of each policy is small, while decisions are taken independently, society may not account for the total social costs, especially if they were hidden under market distortions. The myriad of government agencies and instruments available allow benefits to be conceded independently and in many cases secretly. If there is no social accountability of costs and benefits, old privileges may persist, and new ones are likely to appear.

Feeding a small termite may be a generous act at a negligible cost. If the termites are many, and society only decides the survival of one at time, in the end, it may feed many. And many termites may erode a house.

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